aspects of trade disputes is the necessity of devising some adequate economic means for their real settlement.[46]

CREDITORS' RIGHTS AGAINST THE RECIPIENT OF FUNDS WHICH IMPAIR THE CAPITAL OF A CORPORATION. — In a recent Tennessee case,[1] an assignee for the benefit of creditors sued to recover sums paid out of the capital stock by the corporation to the defendant who accepted them in payment of a personal debt of a stockholder. It did not appear that the defendant knew that the sums were paid out of capital. The court dismissed the plaintiff's bill.

The statutes under which this corporation was organized and issued its capital stock are similar to those usually in force.[2] A fair interpretation of these statutes warrants the conclusion that the legislatures clearly intended the capital stock of a corporation to be a margin of safety for its creditors.[3] The general rule is that a solvent individual is unrestrained master of his assets and may dispose of them freely or even capriciously, provided he remains solvent after such dispositions. But by the grant of corporate privileges, individuals are enabled to profit from the transactions of a business without being exposed to unlimited liability for the obligations incurred in the conduct of that business. The legislatures, therefore, are especially jealous of the rights of the creditors of the corporation. The margin of safety must be preserved. Consequently, the corporation cannot make any and every disposition of its capital it chooses, even though it remain solvent after such disposition.

The contemplated margin of safety for creditors, present and future, may be reduced in consequence of losses sustained in the legitimate undertakings of the corporation. The creditors must be expected to take the risk of those losses. But the legislature does not authorize the corporation to apply its capital to the payment of personal debts of stockholders.[4] Further, the legislature does not intend that the contemplated margin of safety be reduced through the return of the capital,[5]

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[46] *Cf.* Sidney Webb's Memo in REPORT OF THE ROYAL COMMISSION ON TRADE DISPUTES, 18. See also Henry B. Higgins, "A New Province for Law and Order," 29 HARV. L. REV. 13, 32 HARV. L. REV. 189 (reprinted in NAT'L CONSUMERS LEAGUE PUBLICATION No. 106), 34 HARV. L. REV. 105, dealing with the Commonwealth Court of Conciliation and Arbitration in Australia.

[1] Memphis Lumber Co. *v.* Security Bank and Trust Co., 226 S. W. (Tenn.) 182 (1920). For the facts of this case see RECENT CASES, page 891, *infra*.

[2] See 1896 LAWS OF NEW JERSEY, c. 185, §§ 29, 47, 48; 1890 LAWS OF NEW YORK, c. 564, §§ 42, 44, 57; and compare with 1905 ACTS OF TENNESSEE, c. 174, § 1; 1915 PUBLIC ACTS OF TENNESSEE, c. 108, § 1.

[3] Seignouret *v.* Home Insurance Co., 24 Fed. 332 (1885). See 4 THOMPSON, CORPORATIONS, 2 ed., § 3660.

[4] *In re* Haas Co., 131 Fed. 232 (1904); American Wood Working Machinery Co. *v.* Norment, 157 Fed. 801 (1908); Ward *v.* City Trust Co., 192 N. Y. 61, 84 N. E. 585 (1908). See 1 COOK, CORPORATIONS, 7 ed., § 3.

[5] Lockhart *v.* Van Alstyne, 31 Mich. 76 (1875). The force of this objection is reduced when a solvent corporation is in liquidation and where the rights of creditors are not involved. Dupee *v.* Boston Water Power Co., 114 Mass. 37 (1873).

whether directly or indirectly, to any or all of the stockholders. Such a return is made if a dividend is paid to stockholders out of capital or if a portion of the capital is paid to them for no consideration other than the surrender of certificates of stock. If the corporation has impaired its capital in any one of these different ways, creditors of the corporation have often been granted relief.[6]

Three theories have been advanced to explain the basis of the injured creditors' right to relief when the capital of the corporation has been impaired. The first theory is that the capital stock of a corporation constitutes a "trust-fund" for the benefit of its creditors.[7] This phrase was not intended to connote a property interest of the creditors in the capital of a solvent corporation, because the corporation is both full legal and equitable owner of its capital.[8] It is simply a convenient way of expressing the fact that, in dealing with its capital, the corporation is under a duty to safeguard its creditors. The second theory declares that innocent persons who extend credit to the corporation on the basis of its professed capital are defrauded by those acts of the corporation which impair its capital.[9] The third theory is that such a voluntary impairment of capital is improper and that appropriate relief must be

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[6] For cases which granted relief to creditors against those who received corporate capital in payment of personal debts of stockholders, see note 4, *supra*.

Creditors and receivers of corporations can recover dividends paid out of the capital of a solvent corporation. Stoltz *v.* Scott, 23 Ida. 104, 129 Pac. 340 (1912); Cornell *v.* Seddinger, 237 Pa. 389, 85 Atl. 446 (1912). See also Davenport *v.* Lines, 72 Conn. 118, 128, 44 Atl. 17, 21 (1899). However, courts have reached a different result when the stockholders received the dividends in good faith. Ratcliff *v.* Clendenin, 232 Fed. 61 (1916); McDonald *v.* Williams, 174 U. S. 397 (1899). See also 2 COOK, CORPORATIONS, 7 ed., § 548. But the corporation itself cannot recover dividends from its stockholders, though paid out of capital, if no element of mistake is present. See Minnesota Thresher Mfg. Co. *v.* Langdon, 44 Minn. 37, 44, 46 N. W. 310, 313 (1890). *Contra*, Main *v.* Mills, 16 Fed. Cas. No. 8974 (1874) (*semble*). Receivers and creditors of corporations may recover from stockholders who received funds reducing the capital stock in a manner not authorized by the legislature. Dane *v.* Young, 61 Me. 160 (1872); Crandall *v.* Lincoln, 52 Conn. 73 (1884); Clapp *v.* Peterson, 104 Ill. 26 (1882). See also Thompson *v.* Reno Savings Bank, 19 Nev. 103, 111, 7 Pac. 68, 69 (1885); 1 COOK, CORPORATIONS, 7 ed., § 281; 4 THOMPSON, CORPORATIONS, 2 ed., § 3661. They may also clearly recover dividends paid out of capital when the corporation was insolvent. Corn *v.* Skillern, 75 Ark. 148, 87 S. W. 142 (1905); Crawford *v.* Roney, 130 Ga. 515, 61 S. E. 117 (1908).

It is not clear from the facts in the principal case whether the corporation was solvent or insolvent when it paid the sums to the defendant. If, in fact, the corporation was insolvent, the decision is utterly indefensible.

[7] The "trust-fund" theory was probably first enunciated by Story, J., in Wood *v.* Dummer, 3 Mas. (U. S.) 308 (1824). Although the Supreme Court of the United States accepted it in Sawyer *v.* Hoag, 17 Wall. (U. S.) 610 (1873) and in Scovill *v.* Thayer, 105 U. S. 143 (1881), yet it cast doubts upon this theory in McDonald *v.* Williams, *supra*. For a comprehensive list of the state courts paying service to this doctrine, see 1 COOK, CORPORATIONS, 7 ed., § 199; 4 THOMPSON, CORPORATIONS, 2 ed., § 3417.

[8] See Hospes *v.* Northwestern Mfg. & Car Co., 48 Minn. 174, 192, 50 N. W. 1117, 1119 (1892).

[9] Hospes *v.* Northwestern Mfg. & Car Co., *supra*; State Trust Co. *v.* Turner, 111 Iowa, 664, 82 N. W. 1029 (1900); Lea *v.* Iron Belt Co., 147 Ala. 421, 42 So. 415 (1906); McDonald *v.* Williams, *supra*. See also 4 THOMPSON, CORPORATIONS, 2 ed., § 3418. This theory would grant recovery only to subsequent creditors who relied on the corporation's professed capital.

given against the consequences of such improper acts.[10] The legislature objects to acts impairing the capital because they are subversive of stability and confidence in a complex, commercial system. The legislative policy can be best subserved not by requiring the creditor to prove a reliance on the corporation's professed capital, but rather by inquiring whether the creditor has, in fact, been injured.[11] Gradually, the courts are beginning to recognize that the third theory affords the most definite, scientific, and adequate basis for the protection of existing and subsequent creditors of the corporation.[12]

Any innocent defendant, not a purchaser for value, who has profited by such an improper act of the corporation, as the payment of dividends out of capital, ought to be required to disgorge the benefit which he has received, or, at least, as much of it as he still retains.[13] If the defendant knew or ought to have known, when he received corporate assets, that they were paid to him in defiance of the legislative intent, he should be required to account for the benefit received.[14] If he received corporate assets in discharge of the personal debt of a stockholder, he should be obliged, at his peril, to ascertain whether the payment to him results in an impairment of the capital stock of the corporation.

Even if the corporation in the principal case were not granted relief, despite a repentance of its improper conduct, yet its assignee for the benefit of creditors should be allowed to recover the corporate assets illegally paid out or their equivalent. For not only does the assignee represent the creditors as well as the corporation,[15] but he has greater rights than the corporation, representing primarily the creditors in cases where the corporation has been guilty of a wrong with respect to them.[16]

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[10] Easton National Bank *v.* American Brick Co., 70 N. J. Eq. 732, 64 Atl. 1095 (1906).

[11] Vermont Marble Co. *v.* Declez Granite Co., 135 Cal. 579, 67 Pac. 1057 (1902).

[12] Sprague *v.* National Bank of America, 172 Ill. 149, 50 N. E. 19 (1898); Jones *v.* Whitworth, 94 Tenn. 602, 30 S. W. 736 (1895).

[13] But see McDonald *v.* Williams and Ratcliff *v.* Clendenin, *supra.*

[14] See Edward H. Warren, "Progress of the Law: Corporations," 34 HARV. L. REV. 293–295.

[15] National Trust Co. *v.* Miller, 33 N. J. Eq. 155 (1880). See also WAIT, INSOLVENT CORPORATIONS, §§ 199, 210; HIGH, RECEIVERS, 3 ed., §§ 314, 315.

[16] Scovill *v.* Thayer, *supra*; Glenn *v.* Semple, 80 Ala. 159 (1885).

A statement appears in WAIT, INSOLVENT CORPORATIONS, § 235, to the effect that a receiver has no greater rights than the corporation itself. The authorities are overwhelmingly *contra.* Cole *v.* Satsop R. R. Co., 9 Wash. 487, 37 Pac. 700 (1894); Alexander *v.* Relfe, 74 Mo. 495 (1881); Williams *v.* Traphagen, 38 N. J. Eq. 57 (1884); Pittsburg Carbon Co. *v.* McMillin, 119 N. Y. 46, 23 N. E. 530 (1890); Cardwell *v.* Kelly, 95 Va. 570, 28 S. E. 953 (1898). *Contra,* Republic Life Insurance Co. *v.* Swigert, 135 Ill. 150, 25 N. E. 680 (1890). See HIGH, RECEIVERS, 3 ed., § 315; 5 THOMPSON, CORPORATIONS, 2 ed., § 5159.